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THE CANADA-U.S. FREE TRADE AGREEMENT AND THE AUTO PACT

by

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"If it isn't broken, don't fix it." So goes a favorite saying of politicians. During the recent free trade negotiations, much of the advice directed at the Canadian team was based on the premise that the auto pact was working very nicely indeed; it wasn't broken, and therefore the automotive industry should be left out of the negotiations entirely. Starting from this premise, a number of prominent critics have attacked the auto provisions of the free trade agreement. When Simon Reisman announced that he had negotiated an "auto pact plus," Bob White of the Canadian Auto Workers was ready with a sharp rejoinder: the Canadian negotiators had settled for an "auto pact minus."[1]

The problem is that the critics started from the wrong premise. The auto pact was broken, although in subtle and complex ways. It was not broken in terms of its initial design, which led to a major improvement in the efficiency of the Canadian automotive industry. But it had been worn into disrepair by the passage of time and the overlay of new policies. In particular, the auto pact had become unstable because of Canadian government programs to induce overseas firms to set up manufacturing facilities in Canada. If Canada had gone blissfully along, assuming that nothing was wrong, it is probable that Japanese auto firms operating in Canada would have been subject to U.S. countervailing duty actions by the early 1990s. The two governments could fix the potential mess now. Or they could fix it later, at a much higher cost. Fortunately, they decided to fix it now.

But unfortunately, the story itself is complicated. To help us pick our way through the tangle, I start with a brief summary.

The Case in Brief

Briefly, the main points are the following.

First, Canada and the United States adopted the auto pact in 1965 as a way of avoiding a trade conflict. By providing for bilateral duty-free passage of most automotive products, the auto pact promoted the efficiency of the industry -- an outcome in the common interest of the two countries. But there was no such community of interest regarding the second major feature of the pact -- Canadian production safeguards. These safeguards protected Canadian automotive production from unrestrained competition from the United States.

Second, with the rise of Japanese auto producers, a seemingly minor aspect of the pact -- its multilateral, most-favored-nation design from the Canadian side (explained in Box 1) -- took on much greater significance. For the United States, a question arose: would Japanese firms find Canada a preferred base from which to make additional inroads into the U.S. market?

Third, in its efforts to attract Japanese and other overseas producers, the Canadian government took steps that made the situation unstable. In particular, the Canadian duty remission program represents an export subsidy for Japanese and other non-U.S. firms operating in Canada. In this regard, it is important to recognize the distinction between a duty remission and a duty drawback. A duty drawback, which is legal under the General Agreement on Tariffs and Trade (GATT), involves the refund of a duty paid on a product when that same product is re-exported.[2] Canada's duty remissions provide a rebate when a quite different item is exported; 100 percent of the exported item might have been produced in Canada. For example, a Japanese firm purchasing $10,000 in parts from a Canadian producer and exporting them to the United States (or elsewhere) can obtain a remission of $920 in duties on a $10,000 car imported from Japan. The $920 thus is a rather direct subsidy to the export of parts.

Fourth, under U.S. law, U.S. firms injured by competition from subsidized exports have the right to a countervailing duty, which can be exercised regardless of whether or not the duty is in the interest of the overall U.S. auto industry. Once Asian-owned companies in Canada became sizable exporters of auto products to the United States, which would have been likely by the early 1990s, a successful countervailing duty petition would have been probable in the absence of changes in the Canadian program.

Fifth, the Canada-U.S. Free Trade Agreement includes the following automotive provisions:

1. A phased elimination of remaining tariffs between the two countries.
2. A phased elimination of the Canadian embargo on used car imports.
3. An end to duty remissions based on exports to the other party, as of January 1, 1989.
4. An end to production-based duty remissions by January 1, 1996.
5. A Canadian commitment not to extend auto pact membership to any additional manufacturers other than those that already qualify, or that will have qualified by 1989.[3] (This last provision will allow CAMI -- the joint General Motors-Suzuki operation -- to qualify.) The United States is committed not to introduce comparable programs.
6. Changes in U.S. Foreign Trade Zones, to reduce the advantages from duty drawbacks. These changes, which Canada sought, are in line with the general provision in the agreement to eliminate duty drawbacks for most Canadian-U.S. trade. (A drawback is normally nondistorting. It becomes a source of distortion, however, when a free trade area is formed. Thus, most drawbacks are to be eliminated under the trade agreement, as they were in the European Free Trade Association.)

Box 1

The Auto Pact of 1965

The auto pact provides duty-free entry of new autos, most commercial vehicles, and most original equipment (excluding tires and tubes), provided certain conditions are met.

On the U.S. side, duties were eliminated only on imports from Canada, and is thus a preferential agreement. In order to prevent transshipment of overseas cars and parts through Canada into the U.S. market, the United States permits duty-free entry only to products meeting an origin rule -- that is, only products with 50 percent North American content. Such a rule is standard in duty-free agreements, whether they are broad or confined to a single industry. Note that this rule provides a degree of protection from overseas competition for both U.S. and Canadian producers. (Canadian producers are given preferential access to the U.S. market that is not available to overseas goods shipped through Canada.) Because the United States granted such treatment to Canada, it violated the most-favored-nation clause of the GATT. The United States accordingly obtained a GATT waiver for the auto pact.

On the Canadian side, the privilege of duty-free imports is confined to vehicle manufacturers, who must:

- maintain the pre-agreement ratio of Canadian production of vehicles to their Canadian sales of vehicles (and, in any case, not less than 75 percent);
- maintain, in the production of vehicles in Canada, Canadian content equal to that in the 1964 model year. (This condition was significant only during the early years of the pact.)

In addition, Canadian automobile producers submitted "letters of undertaking" to the Canadian government, committing themselves to:

- increase Canadian value added by at least 60 percent of the growth in their Canadian sales, plus an additional $260 million by the 1968 model year.

Note that this last safeguard is a value-added requirement, not a content requirement. The Canadian value added can be exported, rather than just being sold at home. By replacing the content requirement with a value-added requirement, the auto pact allowed Canadian producers to specialize on longer, more efficient production runs.

Under the pact, a manufacturer meeting the safeguards can import duty free into Canada from any country. Thus, Canada did not grant the United States a preference, and was not required to seek a GATT waiver. The safeguards provide Canadian producers with protection from non-Canadian products, whether from overseas or from the United States. The right to import duty free from any country is inseparably linked to the safeguards. If there were no safeguards, the Canadian auto tariff would be applied to overseas producers; otherwise, it would be meaningless. Put another way, the safeguards are enforced by the duties to be paid if they are not met.

Point (3) greatly eases the risk of a U.S. countervailing duty action; the time bomb represented by the Canadian duty remission program is being defused. Points (4) and (5) deal with the less focused frictions that can arise because of exports to the United States by overseas auto firms operating in Canada.

Finally, The automotive provisions of the trade agreement add significantly to the stability of the Canadian-U.S. trade relationship. We cannot be certain that the negotiators reached the very "best" agreement, but the agreement is better than some of the more obvious alternatives -- in particular, the option of doing nothing on automobiles.

Now for some of the details.

Setting the Stage:
The Auto Pact of 1965

The auto pact was not the result of any grand design. Rather, it came about through a dynamic process -- Canadian initiatives to deal with problems faced by Canadian producers in the early 1960s, reactions by U.S. producers to these initiatives, the threat of a major trade dispute, and hurried negotiations to avoid a showdown.

In the early 1960s, the Canadian auto industry was quite inefficient by U.S. standards. It was protected by a tariff of 17.5 percent on automobiles and by the requirement that Canadian-built cars include Canadian content of approximately 60 percent. In order to promote specialization and efficiency, Dean Vincent Bladen, in his one-man Royal Commission, proposed that the content requirement be replaced with a Canadian value-added requirement. Canadian-made parts would be counted against the 60 percent whether or not they were actually "contained" in Canadian-built cars. They could be exported instead. There would be an incentive for Canadian parts production to be concentrated on fewer items, each produced more efficiently, at higher volume.

The Canadian government passed over Bladen's suggestion. But it did introduce major changes in automotive policy in 1962 and 1963 aimed at increasing Canada's share of overall North American production. Auto firms could earn remission of the 25 percent Canadian duty on engines and transmissions by increasing their exports of automotive parts, whether they produced these parts themselves or bought them from outside Canadian suppliers.

This raised a major question in the United States: did not the duty remission program represent a 25 percent subsidy to Canadian parts exports? (Each additional $100 in parts exports was rewarded with a $25 reduction in duties payable on imports of engines or transmissions.) A number of U.S. parts producers thought such duty remissions did constitute a subsidy, and complained to the U.S. Treasury Department. When the Treasury Department proved unresponsive, a radiator manufacturer sued to force it to impose a countervailing duty, as required by law. Most observers thought the manufacturer would win.

Faced with the prospect of a U.S. countervailing duty action and Canadian retaliation, the two governments hurriedly negotiated the auto pact, which provides duty-free automotive trade, subject to the safeguards summarized in Box 1. The pact provided Canada with one major advantage over the duty remission program of the 1962-63 period: Canadian producers no longer had to pay U.S. duties on automotive products exported in the effort to gain longer, more efficient production runs.

In passing, note that this history had significance beyond the auto industry. The U.S. Treasury Department had been reluctant to enforce what had seemed like a straightforward and unambiguous countervailing duty law. This reluctance re-

inforced the growing concern of U.S. producers that their legal rights were being sacrificed to the broader objectives of foreign policy. As a result, pressures increased for a further codification of the rights of firms injured by foreign subsidies; ensuing U.S. legislation specifically rejected the idea of executive discretion in countervailing duty cases. And administration of the law was shifted from Treasury to the Commerce Department, which was generally considered to be more sympathetic to business.

The Auto Pact:
Sources of Stability and Instability

The auto pact has now survived for almost a quarter of a century; it must have a lot going for it. Indeed it does. It has improved efficiency, particularly in the Canadian auto industry, which has been able to lengthen its production runs. Now that the big three producers have adjusted to the pact, they have a great stake in its continuation; any major disturbance of the pact would require them to undo the reorganization of the past two decades.

Canadian safeguards have been a source of friction between the two countries, however, in part because the United States understood that they would be only temporary arrangements to ease the transition to free trade. On occasion, the safeguards issue has threatened to break into an open dispute. In 1971, the U.S. government made a preliminary decision -- soon reversed -- to include an announcement of an abrogation of the pact as part of President Nixon's "New Economic Policy". The objective was not actually to end the pact, but to pressure Canada into negotiating seriously over the safeguards. In 1975, the Senate Finance Committee asked the U.S. International Trade Commission to investigate whether Canada had "fully complied with the letter and spirit of the agreement by phasing out the so-called 'transitional provisions.'" The commission reported that Canada had not done so. Nevertheless, the safeguards have not constituted a mortal threat to the pact. In spite of resentments, U.S. witnesses in 1975 hearings sounded a strong, consistent theme: "Don't terminate the agreement."[4]

However, the rise of Japan as a major force in the North American auto market set in motion a series of events that threatened to disrupt Canadian-U.S. automotive trade, and that probably will still do so if the free trade agreement is rejected.

Not only were North American auto producers subjected to strong new competitive pressures from Japan, but the two countries soon began to compete to attract Japanese and other overseas firms. At first, the results were one-sidedly in favor of the United States. In 1985, Japanese firms produced about 330,000 vehicles (including light trucks) in the United States, but none in Canada. This choice of U.S. over Canadian sites was not simply the result of market forces. The Japanese were responding to political pressures in the United States, and the establishment of plants in Canada would have done little to ease their political problem south of the border.

Canada thus came away empty-handed in the first round of competition for Japanese plants. But the second round is turning out quite differently. According to present plans, the productive capacity for East Asian cars and light trucks in Canada will exceed 300,000 by the beginning of the 1990s, compared with perhaps 1.7 million in the United States. (These figures include General Motors' joint ventures with Toyota in the United States and Suzuki in Canada.) As the Canadian share of planned production is substantially larger than its share of sales, Canada apparently plans to become a significant net exporter of East Asian cars to the United States. This in itself creates some danger of a U.S. reaction. But the incentives that Canada has offered to overseas firms have increased the

likelihood of a U.S. response. Two features of Canadian policy are worth special note: the export-based duty remissions, and the pressures on overseas firms to meet Canadian value-added requirements associated with the auto pact.

Export-Based Duty Remissions Once More

Under the duty remission program, Japanese and other overseas producers operating in Canada have an incentive to export from Canada; they are rewarded in the form of a rebate of duties on imports. For example, a Japanese firm can get back the duty paid on imports of cars from Japan by exporting automotive parts to the United States or elsewhere. This program raises three problems.

First, like the old duty remission program of the 1962-63 period, it represents a rather clear subsidy to exports. In recent years, some U.S. allegations of subsidy have raised complex questions. It is quite understandable, for example, that Canadians feel that the U.S. government arbitrarily broadened the definition of subsidies in the softwood lumber case. But there is little doubt that export-based duty remissions constitute an export subsidy.

Second, the current duty remission program is even more objectionable to the United States than was the old program of 1962-63. The old program was associated with two-way trade between Canada and the United States; an export subsidy was provided when firms earned the remission of duties paid on Canadian imports from the United States. Under the current remissions, Japanese firms operating in Canada can use exports to the United States -- which are duty free under the auto pact -- as a way of earning the remission of duties on imports from Japan. In other words, the current duty remission program will tend in the future to suck in more imports from Japan and push subsidized exports to the United States. (This already happens to some degree; an auto firm need not actually be a producer of cars in Canada to benefit from remissions. But if the remission program had been retained, it would have become much more important as Canadian production by Japanese-owned firms increased.)[5]

Third, the history of the remission issue raises questions as to whether Canada is cutting corners. When the two countries signed the auto pact, the United States obtained an end to the troublesome duty remission programs of 1962-63. Yet Canada has brought duty remissions back, and in the much more objectionable form explained in the previous paragraph. When Canada introduced a duty remission program for Volkswagen in 1978, the United States objected. Canada seemed to understand the objection; duty remissions offered to Japanese firms in 1980 were to be granted only in reward for exports to countries other than the United States. But in 1984-85, the U.S. exclusion was dropped.

Although there is a great pool of goodwill toward Canada in the United States, these three points would make it very difficult for the U.S. government to take a conciliatory stance in the event of a showdown over duty remissions. The duty remission program is more trouble than it is worth to Canada. It is probably true that the duty remission scheme has provided some incentive for Japanese firms to establish operations in Canada, although it is also undoubtedly true that other factors are more important -- competitive wage rates, the exchange rate, and the 9.2 percent tariff that can be avoided by producing in Canada. And it is doubtful that the duty remission scheme will provide much additional incentive in the future. Because of strong U.S. objections and the threat of a U.S. countervailing duty, any firm setting up shop in Canada would be foolish to count on gaining remissions through duty-free exports to the U.S. market.

Indeed, the duty remission program casts a threat over the auto pact itself.

While it is possible that the auto pact, duty remissions, and U.S. countervailing duties might have coexisted, it is also possible that a set of actions and counteractions might have led to an unraveling of the pact -- an outcome that neither country wants. Stability is in the interest of both countries. In a speech on February 3, 1988, Moe Closs, President of Chrysler Canada, supported the free trade agreement as a way of saving the auto pact. Getting rid of export-based duty remissions as part of the overall free trade agreement was no great concession. What Canada gave up was a migraine headache.

Overseas Producers:
Should They Qualify for the Pact?

In the free trade accord, Canada also agreed to limit membership in the auto pact to its present participants, plus General Motors-Suzuki. This represents a reversal of Canadian policy, which had been moving toward the requirement that all firms selling significant numbers of automobiles in Canada meet the auto pact safeguards. A second set of duty remissions -- this time as a reward for meeting production targets -- apparently was intended as a transitional step toward fully meeting the safeguards, with the related duty-free privileges.

Participation in the pact by overseas firms would have raised some of the same issues as the export-based duty remission program, although in a more complicated way. To highlight the similarity, if a Japanese auto firm were to achieve pact membership by meeting Canadian production targets, then it would not have to pay duties on its imports from Japan. But, of course, to meet the production targets, it would be encouraged to export from Canada. The most obvious place to send exports would be to the duty-free U.S. market. Again, as in the case of export-based duty remissions, Canada would be using the carrot of duty-free imports from Japan as a way of pushing exports into the duty-free U.S. market.

The economic and political reasons for Canada's wanting to keep the pact open to non-U.S. participants are relatively straightforward. Most obviously, additional overseas trade can provide diversification and a balance to the overwhelming U.S. presence. But the reasons why the United States should object to an arrangement that may suck in imports from Japan and push exports to the United States are also easy to understand. An obvious question arises from the U.S. side: if Canadians and Japanese want an arrangement for duty-free imports into Canada, to be balanced with exports from Canada, should not Japan, rather than the United States, take the Canadian exports? Or, to put it another way, if Canada and Japan wanted to arrange an auto pact of their own, with duty-free exports in both directions, then that would be one thing. But, as seen from the U.S. side, it is unreasonable for Japan to freeload on the Canadian-U.S. pact by exporting duty free to Canada and expecting the United States to absorb the duty-free exports of Canadian-based Japanese firms, while at the same time maintaining tariff and other barriers to a flow of auto products from Canada back to Japan.

From the U.S. side, one way out of the problem would have been to request that Canada bilateralize the auto pact. Under the pact, the United States provides preferential duty-free entry to Canadian products; it would not be reasonable to expect Canada to provide in return preferential duty-free entry only to U.S. products. But such a bilateralization would create problems for U.S. auto firms operating in Canada. Although the overwhelming majority of their imports into Canada come from the United States, they also benefit from duty-free imports from overseas. These firms now import about $3 billion yearly from such non-U.S. sources. With a 9.2 percent Canadian tariff on autos and parts, this

means that they save about $300 million annually from the multilateral provisions on the Canadian side of the auto pact. Thus, some months ago, when the U.S. government was considering whether to request that Canada bilateralize the pact, the U.S. Motor Vehicle Manufacturers Association said it was "extremely alarmed."[6]

The outcome of the negotiations was reassuring to present participants in the auto pact: they will continue to enjoy duty-free imports into Canada from any country. But the door has been shut to new firms. And production-based duty remissions, which represent a half-way station to pact membership for Japanese and other overseas-owned firms, will be terminated by January 1, 1996.

In combination with the end of export-based duty remissions, these steps mean that the United States will no longer face the prospect of Canadian-based Japanese firms receiving an incentive, in the form of duty waivers, as a reward for exporting to the United States. But if they meet the 50 percent North American content rule, these firms still will have duty-free access to the U.S. market.

Did Canada give up too much on automotive trade? Insofar as the export-based duty remissions are concerned, the answer clearly is no -- the remissions were almost certain to have drawn a U.S. countervailing duty. It is harder to make predictions as to what would have happened if Canada had refused to give up production-based remissions or had insisted that Japanese firms be allowed to participate in the pact. But it seems unlikely that the United States would have acquiesced in large imports from Japanese firms in Canada if such firms had been rewarded for those exports by remissions of Canadian duties. The free trade agreement greatly stabilizes the basis for duty-free passage of autos; it substantially reduces the chances of a confrontation between the two countries.

This is not to argue that we are completely out of the woods. Production-based remissions may still be a source of trouble, as they will remain in force until the end of 1995. (In contrast, export-based remissions end on January 1, 1989.) One difficulty is that production-based remission agreements between the Canadian government and the auto firms remain secret (except for a highly censored version of the agreement with General Motors-Suzuki). U.S. government requests for copies have been rebuffed. Congress is likely to react negatively; it is being asked to acquiesce in the continuation of production-based duty remissions for the next seven years without knowing the details.

The Auto Pact: Plus or Minus?

Did the free trade agreement preserve the auto pact? The answer is yes. Consider the two central features of the pact:

- Duty-free passage of auto products between the two countries. This clearly has been maintained and extended to additional products, such as tires and replacement parts (see Box 2). It is more secure, because the danger of countervailing duties will be reduced with the elimination of duty remissions.
- Canadian safeguards. These have been maintained, although it is possible to argue that they were either strengthened or weakened. They were strengthened, in that the United States has at least tacitly accepted their legitimacy. (When the negotiations hit the moment of truth, it was not clear that the United States actually wanted the safeguards to be abolished. That would have meant the pact's complete bilateralization, and an end to duty-free imports into Canada from overseas by U.S.-owned companies.) It is also possible, however, to take the view that they were weakened, because of the phased elimination of one of the major incentives to comply -- namely, the Canadian tariff on U.S. auto products.

Box 2

How the Free Trade Agreement Changes the Auto Pact

The Canada-U.S. Free Trade Agreement leaves most of the auto pact undisturbed, with three notable exceptions:

- There will be a phased elimination of remaining duties on Canadian-U.S. automotive trade, including duties on tires and replacement parts.
- After the 1989 model year, the auto pact will be closed to new members; no new firms will be able to qualify for duty-free imports into Canada from third countries. A firm remaining outside the pact will be treated like a nonautomotive company. It will pay duties on materials and components imported into Canada from third countries, and it will be able to export products duty free to the United States if they meet the 50 percent North American content rule. Similarly, the firm will be entitled to import parts duty free from the United States if they contain 50 percent North American content.
- The basis for calculating 50 percent North American content is redefined, resulting in an effective increase.

The first change means that the biggest stick enforcing the safeguards will be phased out. After this is completed in 1998, U.S.-owned firms operating in Canada will no longer face the prospect of having to pay duties on imports from the United States if they fail to meet the safeguards. However, they will still face duties on their imports from overseas. As argued in the text, the smaller stick of duties on imports from overseas is more credible than the large stick. On the Canadian side, an important aspect of multilateralism remains: current auto pact firms that meet the safeguards will still be able to import duty free from any country.

The second change represents a significant departure from equal multilateral access to the Canadian market. Present members are predominantly U.S. (although Volvo is included); those who will be excluded are predominantly foreign. However, there would seem to be no need for Canada to obtain a GATT waiver. Under GATT Article XXIV, preferences are permitted in the case of a free trade agreement covering substantially all products, and the Canadian-U.S. agreement meets this criterion.

However, the big three auto producers still have a strong incentive to comply -- the $300 million saved annually on duties that would otherwise have to be paid on imports from overseas sources. Critics of the free trade agreement apparently have overlooked this strong incentive. For example, Premier David Peterson of Ontario has spoken of the "elimination of Canadian value-added requirements,"[7] while Bob White has spoken of an auto industry "without safeguards."[8]

It is true that an even stronger incentive will be eliminated -- namely, the threat of the huge duties that would become payable on imports into Canada from the United States in the event that auto firms failed to meet the Canadian assembly safeguard. But one may ask whether this threat could be carried out in practice. Like an atomic weapon, it may be too powerful to use. Before Canada presented auto firms with huge duty bills on imports from the United States, serious thought presumably would

have to be given to the danger of U.S. retaliation. Furthermore, a firm that fails to meet its commitments may already be in financial trouble, and a huge duty bill might push it over the brink into bankruptcy. Because of such dangers, duties have not in fact been collected on U.S. automotive imports in the past when firms fell short of the safeguards -- as occurred in 1980, for example. A more modest weapon -- duties on imports from overseas -- is more usable, both because of its size and because it does not apply to exports from the United States. (Japan would be much less likely to retaliate against the collection of such duties on Japanese exports to U.S.-owned companies in Canada, because Japan has no duty-free agreement with Canada and because Japanese-owned companies in Canada will already be paying duties.) A $300 million incentive should be sufficient to ensure compliance. This is particularly so as Chrysler, which previously was in the weakest position to comply, now has much more elbow room with the recent acquisition of American Motors and its up-to-date Canadian facilities.

Parts Manufacturers: The Rule of Origin

On both sides of the border, parts manufacturers are less satisfied with the outcome of the free trade agreement than are assemblers of automobiles. They were only partly successful in pushing for a stricter "rule of origin" for duty-free Canadian-U.S. automotive trade. The method of calculating the 50 percent North American content requirement was changed, raising its effective rate. But the parts producers did not get it increased to 60 percent or more as they had wanted. The Automotive Parts Manufacturers' Association of Canada recently declared that the auto elements of the free trade agreement are unacceptable if the requirement is not raised to 60 percent.[9]

In passing, note that the content requirement -- a standard provision in a free trade agreement -- is quite different from the Canadian value-added requirement of the safeguards, which is retained and which protects the Canadian parts industry from competition from all countries, including the United States. In contrast, the North American content requirement protects both U.S. and Canadian parts producers from outside competition. Parts producers on both sides of the border therefore have a common interest in a high North American content requirement, whereas U.S. parts producers are opposed to Canadian safeguards. On the other hand, auto assemblers generally have an interest in keeping the North American content requirement from rising; a higher content makes it more difficult to qualify for duty-free passage. (The smaller overseas-owned firms -- such as the Japanese subsidiaries -- find it harder to meet content requirements and, therefore, have a stronger interest in keeping down the content requirement than do U.S.-based firms.) Thus, the main difference of opinion regarding the North American content requirement was within each country, rather than between the two countries. This is so even if we confine our attention to the interests of producers, and ignore those of consumers.

Nevertheless, there was some difference in emphasis between the two countries. The U.S. government was somewhat more favorably disposed to a higher content requirement than was the Canadian government. The obvious explanation for the Canadian negotiators' relative lack of enthusiasm for a high content requirement is that the requirement applies mainly to southbound traffic; thus, it is more significant as a barrier to Canadian exports than imports.[10] In particular, keeping the content requirement from rising further will provide one advantage to Canada: Canadian-based Japanese firms will be able to sell into the U.S. market more easily. Thus, the Canadian parts producers' complaint that they did not get a 60 percent North American content requirement, is not an indication that the Canadian team was out-negotiated. It

is doubtful that a higher percentage was in Canada's interest. Furthermore, the case for not raising the content further is strengthened when the interests of consumers are taken into account. The higher the content requirement, the more expensive are automotive products likely to be.

Conclusion

The principal point of this paper is that, in the absence of a free trade agreement, the threat of instability was hanging over Canadian-U.S. auto trade. Although the auto pact generally has worked well, contributing to two-way trade and efficiency, there were dangers of a U.S. reaction to recent Canadian policies, most clearly the duty remission programs. The automotive provisions of the free trade agreement greatly lessen the chances of U.S. countervailing duty actions. The wish to avoid such actions was one of the Canadian government's major reasons for entering into the free trade negotiations.

The auto provisions of the free trade agreement grew out of the same dynamic process as the auto pact itself: unilateral Canadian action to deal with an unsatisfactory situation, the threat of a U.S. countervailing duty, and an international agreement to avoid an explosion. The provisions, it is true, are a bit untidy, but they represent a reasonable accommodation of conflicting views on both sides of the border.

Those who oppose the auto provisions can do so on two grounds: first, that there was no major danger and that the auto pact "wasn't broken" or, second, that there were alternative, preferable ways to deal with the threat of instability.

The major objections have come from those who take the first position, and who strongly argued some months ago that automotive trade should be excluded from the negotiations. Bob White has been particularly outspoken; his views must be taken seriously because he represents the auto workers. He has talked about the dangers of living in a "dream world." Specifically, he says that, "if we think we are so competitive we are going to shift jobs in the auto industry from the U.S. to Canada significantly under this agreement, then we really are in a dream world."[11] But is Mr. White himself awake to the dangers? Does he think that Canada can hold steadfast to its past auto policies without inviting a U.S. countervailing duty? Does he really expect the United States to allow Canada to

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capture a significantly larger share of the U.S. market, not through being especially competitive, but through gimmicks such as duty remissions?

The recent negotiations really involved two sets of topics, one applying to trade in general and one intended to deal with the growing threat of a conflict in the auto sector. If the overall free trade agreement is rejected, the auto threat will remain. Those who oppose the agreement because of its auto terms are invited to spell out their preferred policies. Do they want to revert to the status quo ante, ignoring the threat of U.S. countervailing duties and hoping that the problem will simply go away? If so, what plausible reasons do they offer for such a hope, in the light of the duty remission programs and existing U.S. law? If their hope proves to be misplaced, do they have a backup strategy once a countervailing duty action is initiated? If they recognize the dangers of a "do nothing" policy, do they recommend unilateral Canadian concessions, such as the elimination of the troublesome duty remissions and a ruling out of auto pact benefits for additional firms? (White's participation in the White-Lavelle proposals suggests that his answer would be a firm no.)[12] As an alternative, do they recommend the initiation of separate negotiations between Canada and the United States over automotive trade? If so, in what ways do they expect the outcome of such negotiations to be superior to the automotive provisions of the free trade agreement?

Notes

1. Bob White, in House of Commons, Standing Committee on External Affairs and International Trade, Proceedings, November 17, 1987, p. 37.

2. To be precise, there may be some departure from the "same product" rule. For example, if a manufacturer imports, say, bolts, it may put those bolts in the same bin with domestically produced bolts and still get a drawback of duties on bolt imports when the bolt-containing product is exported. The manufacturer does not have to prove that the bolts actually contained in the exports were precisely the ones imported, although drawbacks are limited to the duties paid on the number of bolts actually imported. This modification is designed to avoid highly complex control and accounting problems.

3. The term "membership" is used loosely to mean qualification as eligible manufacturers under provisions similar to those in the pact.

4. U.S. Congress, Senate Committee on Finance, Canadian Automotive Agreement, Washington, D.C., January 1976, pp. vii, ix.

5. For details, see Paul Wonnacott, U.S. and Canadian Auto Policies in a Changing World Environment, CAC 56 (Washington, D.C.; Toronto: Canadian-American Committee, 1987), pp. 24-26; and idem, The United States and Canada: The Quest for Free Trade (Washington: Institute for International Economics, 1987), pp. 79-82. (The text of a duty remission agreement is provided in Annex, 4A, pp. 109-13 of the latter study.)

6. Thomas Hanna, President of the Motor Vehicle Manufacturers Association, in a letter to Ambassador Peter Murphy, June 22, 1987.

7. Hon. David Peterson, Notes for Remarks to the Canadian Club and the Empire Club, Toronto, November 4, 1987, p. 13.

8. White, p. 37.

9. Automotive Parts Manufacturers' Association of Canada, Press Release, December 9, 1987.

10. Because the safeguards protect Canadian production, the 50 percent rule has applied in the past only to exports from Canada to the United States. Over the next ten years, as Canadian tariffs on U.S. automotive products are phased out, the 50 percent rule will also be applied to Canadian automotive imports from the United States by nonparticipants in the auto pact (such as Toyota and Honda). Note that U.S. barriers to Canadian cars lacking a high North American content are of interest to Canadian parts producers because such barriers encourage them to purchase Canadian parts, rather than parts from third countries.

11. White, p. 37.

12. The White-Lavelle report recommended that all sellers of vehicles in Canada be required to meet the standards of the auto pact. See An Automotive Strategy for Canada, Report of the Federal Task Force on the Canadian Motor Vehicle and Automotive Parts Industries (Ottawa, 1983), p. 107.